BETTER MARKETS

July 24, 2015

Robert de V. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Re: Liquidity Coverage Ratio—Treatment of U.S. Municipal Securities as High-Quality Liquid Assets, Docket No. R-1514

Dear Mr. Frierson:

Better Markets, Inc.[1] appreciates the opportunity to comment on the rule proposed by the Board of Governors of the Federal Reserve System ("Board") ("Proposed Rule"). The Proposed Rule would classify U.S. general obligation municipal securities as "High-Quality Liquid Assets" ("HQLAs") under the Board's liquidity coverage ratio requirement ("LCR").

Better Markets opposes the Proposed Rule because it will weaken the LCR, making it more likely that large, complex financial institutions will once again turn to the Federal Reserve in times of severe economic stress to meet their liquidity needs. In addition, the Proposed Rule delegates the responsibility for determining whether municipal securities are "investment grade" such that they would count as HQLAs to large, complex financial institutions.[2]

However, the Proposed Rule fails to provide concrete guidelines or standards to guide those determinations, which will enable and encourage the large, complex institutions subject to the LCR to game the system by counting municipal securities of questionable creditworthiness as HQLAs. The lack of concrete guidelines and standards in the Proposed Rule will also make it difficult for the Board and other financial regulators to monitor and challenge questionable determinations of creditworthiness.

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[1] Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process regarding the capital and liquidity requirements for large, complex financial institutions.

[2] As the Board notes in its Release, the Proposed Rule delegates the responsibility for making this determination to large, complex financial institutions because the Dodd-Frank Act prohibits references to credit ratings in federal statutes and regulations. "Liquidity Coverage Ratio: Treatment of U.S. Municipal Securities as High-Quality Liquid Assets," 80 *Federal Register* 30383, 30385 n. 13 (May 28, 2015).

1825 K Street, NW, Suite 1080, Washington, DC 20006 | TELEPHONE (1) 202.618-6464 | FAX (1) 202.618.6465 | WEBSITE bettermarkets.com

INTRODUCTION

In the Board's notice of proposed rulemaking (Release), the Board notes that the "LCR is designed to promote the short-term resilience of the liquidity risk profile of large and internationally active banking organizations . . . thereby improving the banking sector's ability to absorb shocks arising during periods of significant stress." The LCR seeks to improve the resilience of the banking sector by requiring large and internationally active banking organizations to maintain an amount of HQLAs that will allow them to meet their total net cash outflows over 30 calendar days during a period of significant stress.

As the Board's Release points out, "only a limited number of asset classes" qualify as HQLAs. These asset classes are those "that have historically been used as a source of liquidity" in the U.S. during periods of significant stress and "have a demonstrable level of liquidity." The question raised by the Board's Release is whether U.S municipal securities meet these criteria and should therefore be counted as HQLAs under the LCR. The Board has concluded that some U.S. general obligation municipal securities are "liquid and readily marketable," and may be included as HQLAs provided they meet certain criteria.

Among other things, U.S. general obligation municipal securities may be counted as HQLAs if they are "investment grade." But the Proposed Rule does not specify the criteria that a municipal security would have to meet to be considered "investment grade." Nor does the Proposed Rule provide specific guidance to large, complex financial institutions for determining whether a municipal security is "investment grade." Instead, the Proposed Rule "relies on an assessment by the bank of the capacity of the issuer to meet its financial commitments."[3]

Better Markets strongly supports the intent behind the LCR. The Board and other financial regulators adopted the LCR to ensure that large, complex financial institutions can meet their own liquidity needs during times of extreme stress in the financial system, rather than relying on the Federal Reserve's emergency lending authority as they did during the 2008 financial crisis. If the LCR is implemented in such a way that only those assets that truly "have a demonstrable level of liquidity" are counted as HQLAs, the LCR will help address one of the problems that helped precipitate the financial crisis and significantly worsened it.

But the Board's Proposed Rule classifying some kinds of municipal securities as HQLAs compromises the integrity of the LCR. As a result, large, complex financial institutions may once again find themselves relying on the Federal Reserve's emergency authorities rather than their own assets to meet their liquidity needs during periods of significant stress. And by delegating to each individual institution subject to the LCR the authority to determine for itself whether a municipal security is "investment grade," the Proposed Rule invites a lack of uniformity as well as potential confusion and complexity. Moreover, this delegation of authority will also enable and encourage certain of these institutions to game the system,

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[3] "Liquidity Coverage Ratio: Treatment of U.S. Municipal Securities as High-Quality Liquid Assets," 80 *Federal Register* 30383, 30385 n. 13 (May 28, 2015).

further undermining the LCR, and it will make implementing and policing the rule needlessly more difficult.

BACKGROUND

Before the financial crisis, regulators and experts believed that the only thing that financial institutions had to worry about was their solvency: these institutions had to make sure that the value of their assets exceeded their liabilities. As long as the institution's assets were worth more than its liabilities, almost everyone thought that a bank would be able to borrow what it needed to meet its obligations as they came due.[4] The financial crisis, however, demonstrated that banks not only needed to maintain an apparent positive net worth but also had to have enough cash on hand to meet their obligations as they came due. In other words, banks needed to worry about their liquidity as well. As Princeton University economist Alan Blinder explains,

> The distinction between *insolvency* and *illiquidity* is one of those lessons that both economists and financial market participants probably learned too well. The crisis made us all rethink it.
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> In principle, the difference is stark. A firm is *insolvent* when the value of its liabilities exceeds the value of its assets, making its net worth negative. Its next stop is probably bankruptcy court. A firm is *illiquid* when it is short on cash, even if its balance sheet displays a healthy net worth. In such cases, the firm needs short-term credit, not euthanasia. Insolvency is a fatal disease; illiquidity is a bad cold . . . .
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> But here's the problem. A company facing a severe cash squeeze—especially if its usual suppliers of funding have turned their backs on it—may be forced into fire sales of its less liquid assets. Which may mean selling them at exceptionally low prices, if indeed, it can sell them at all. Which reduces net worth. The problem is worse if you're a financial company, for at least two reasons. One is that moving cash is your business. Your daily inflows and outflows of cash are likely to be extremely large compared with, say, a comparably sized manufacturing company. The second is that your leverage is likely to be high enough that even modest percentage declines in asset values translate into severe percentage declines in net worth. And it's much worse if lenders and counterparties lose confidence in you, for then the credit spigot may be turned off. . . .

[4] *See* Jean –Charles Rochet and Xavier Vives, "Coordination Failures and the Lender of Last Resort: Was Beagehot Right After All?" 2 *Journal of the European Economic Association* 1116 (2004), *available at* http://blog.iese.edu/xvives/files/2011/09/109.pdf. ("Several authors have argued that [the view that the central bank should act as a lender of last resort] is now obsolete: in modern interbank markets, a solvent bank cannot be illiquid.").

> For these reasons, a severe liquidity crunch can destroy a financial company, such as a commercial bank or an investment bank, even if its balance sheet is basically okay. Illiquidity can quickly turn into insolvency—as happened to Bear Stearns and, later, to Lehman Brothers.[5]

In short, financial institutions need both capital and liquidity. As the economist Charles Goodhart put it in 2007, "Liquidity and solvency are the heavenly twins of banking, frequently indistinguishable. An illiquid bank can rapidly become insolvent, and an insolvent bank illiquid."[6] Before the financial crisis, regulators focused far more attention on capital than on liquidity. In the run-up to the crisis, the financial system increasingly relied on the government to act as a backstop source of liquidity. As Professor Goodhart put it,

> Why should the banks bother with liquidity management when the Central Bank will do all that for them? The banks have been taking out a liquidity 'put' on the Central Bank; they are in effect putting the downside of liquidity risk to the Central Bank.[7]

Because large, complex financial institutions could rely on central banks to provide liquidity in times of stress, they failed to maintain a sufficient amount of HQLAs to see them through times of stress.

Given the catastrophe caused by grossly insufficient liquidity before and during the financial crisis, financial regulators—for the first time ever—adopted formal standards that governed liquidity management at large, complex financial institutions. The Basel Committee on Banking Supervision reached a consensus that banks should have enough cash or easily monetizable assets (such as government securities) on hand to survive for 30 days if their usual sources of short-term funding disappear. This requirement is the LCR, which

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5 Alan Blinder, *After the Music Stopped: The Financial Crisis, the Response, and the Work Ahead* 103-04 (2013). The line between liquidity is exceedingly difficult to determine. Economists and historians continue to debate whether the financial crisis was caused by a liquidity crunch or the insolvency of large institutions, and whether institutions such as Bear Stearns and Lehman Brothers were illiquid or insolvent. The "liquidity crisis" narrative is set forth in Markus K. Brunnermeier, "Deciphering the Liquidity and Credit Crunch 2007-2008," 23 *Journal of Economic Perspectives* 77 (2009), *available at* http://www.princeton.edu/~markus/research/papers/liquidity_credit_crunch.pdf and Gary Gorton, *Slapped by the Invisible Hand: The Panic of 2007* (2010). But as Charles Goodhart and Dimitri Tsomocos have observed, the idea "that the start of the financial crisis in August 2007 was just a liquidity problem ... was always ludicrous," given the losses suffered by large financial institutions on subprime mortgages. Charles A.E. Goodhart and Dmitri Tsomocos, "Liquidity, Default, and Market Regulation," VoxEu (Nov. 12, 2009), *available at* http://www.voxeu.org/article/liquidity-default-and-market-regulation. It does not appear unreasonable to suggest that the institutions that were at the center of the financial crisis were both illiquid and insolvent.

6 Charles A.E. Goodhart, "Liquidity Risk Management," London School of Economics Markets Group Paper (Oct.2007), *available at* http://www.lse.ac.uk/fmg/documents/specialPapers/2007/sp175.pdf.

7 *Id.* As mentioned, the line between "illiquidity" and "insolvency" is a difficult and dangerous one to draw. The mantra of central bankers is to "lend freely to solvent institutions, against good collateral and at penalty rates." But as Professor Goodhart points out, "Just as it is the métier of god to have mercy on sinners, however heinous the sin, so it is the métier of central banks to provide liquidity to systemic financial institutions, however dubious are the assets on their balance sheet." *Id.*

is defined as a financial institution's stock of HQLAs divided by its net cash outflows over a 30-day time period under an acute liquidity stress scenario.

Unsurprisingly, as Professor Goodhart's observation about the "liquidity put" makes clear, the financial services industry voiced many complaints about the LCR. Among other things, the industry complained that the stock of HQLAs was defined too narrowly, so that few assets counted as HQLAs. In particular, the industry complained that municipal securities should have been counted as HQLAs.[8] But as the regulatory agencies pointed out—and as the Board explains in its notice—the funding of many U.S. municipal securities in the repurchase market is limited, which lessens the opportunity for companies to convert the securities to cash quickly during a period of significant stress.

SUMMARY OF COMMENTS

Given the flaws in liquidity management in the world's largest financial institutions that helped precipitate and exacerbate the financial crisis, Better Markets strongly supports the LCR.

However, the Board's Proposed Rule to include U.S. general obligation municipal securities as HQLAs—even subject to the limitations described in the Proposed Rule—undermines the LCR. By allowing large, complex financial institutions to meet their LCRs by counting U.S. general obligation municipal securities as HQLAs, the Proposed Rule makes it more likely that large, complex financial institutions will again find themselves exercising a "liquidity put" against the Federal Reserve in a time of great financial stress. In fact, the Proposed Rule may make the financial system even more fragile because it gives market participants and regulators a false sense of security and comfort: Large, complex financial institutions may appear to satisfy the LCR, but the municipal securities they counted as HQLAs will not provide them with the liquidity they need during times of stress.

In addition, the Proposed Rule delegates the responsibility for gauging the creditworthiness of a U.S. general obligation municipal security to financial institutions. Such a delegation effectively nullifies the requirement that such securities be "investment grade" to be counted as HQLAs. At a minimum, the Proposed Rule should set forth standards that are specific, strong, and uniform to ensure that such securities are in fact "liquid and readily marketable." And to ensure that the Board and other regulators can independently verify that large, complex financial institutions have complied with the Board's requirement that these securities are "investment grade," the Proposed Rule should also set forth standards that are clear, concrete, and mandatory. In addition, the Proposed Rule should require those institutions to document their credit analyses to facilitate regulatory oversight.

8 *See, e.g.*, *Economics of Contempt*, "Stay Classy, JPMorgan," (May 10, 2011), *available at* http://economicsofcontempt.blogspot.com/2011/05/stay-classy-jpmorgan.html.

COMMENTS ON THE BOARD'S PROPOSED RULE

Allowing U.S. general obligation municipal securities to count as HQLAs weakens the LCR.

As the Board itself notes in its Release, "only a limited number of asset classes . . . are included as HQLA."[9] The reason is clear: To serve as a source of liquidity in times of great financial stress, HQLAs must have "historically been used as a source of liquidity in the United States during periods of significant stress" and "have a demonstrable record of liquidity." In determining whether a class of financial assets meets these criteria, the Basel Committee on Banking Supervision has encouraged national regulators to examine the risk profile of the asset as well as activity and volume in the asset's market. Using these measures, U.S. general obligation municipal securities fall short.

As the Board points out in its Release, U.S. financial regulators have observed that the repurchase market for many U.S. municipal securities is limited. Even in times that are not stressed, the market for U.S. municipal securities is one in which most municipal securities trade infrequently. According to the U.S. Securities and Exchange Commission, in 2011—three years after the financial crisis impaired liquidity in the financial markets—99 percent of outstanding municipal securities did not trade on any given day.[10] And of the municipal bonds that did trade, the trading frequency averaged one and a half times per year.[11] Because most municipal securities are not actively traded, they do not have a quoted price. Instead, they have an estimated price, which is extrapolated from their sparse trading history and other data derived from the municipal-securities market.

Thus, even under the best of circumstances under normal market conditions, most municipal securities are very thinly traded and do not have a price that can be easily ascertained. In times of stress, of course, these securities will be even harder to trade or use as collateral, because market participants will not know how to price these securities. Rather than serving as a source of liquidity in a time of stress, most municipal securities will likely become an illiquid asset on the books of a financial institution. And as market conditions deteriorate, an institution that attempts to sell a municipal security to increase its liquidity may find itself doing so at a fire-sale price that does not reflect the security's estimated value. Put another way, not only will such municipal securities fail to serve the purpose envisioned by the LCR, they will in fact accelerate the very decline and stressed circumstances that the LCR was intended to prevent.

Thus, in such a scenario, not only will the municipal security fail to provide the liquidity contemplated under the LCR, the downward pressure on the security's price will

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9 "Liquidity Coverage Ratio: Treatment of U.S. Municipal Securities as High-Quality Liquid Assets," 80 *Federal Register* 30383, 30384 (May 28, 2015).

10 U.S. Securities and Exchange Commission, *Report on Municipal Securities Market* (July 31, 2012), *available at* http://www.sec.gov/news/studies/2012/munireport073112.pdf.

11 U.S. Securities and Exchange Commission, *Report on Transactions in Municipal Securities* (July 1, 2004), *available at* https://www.sec.gov/news/studies/munireport2004.pdf.

also push the financial institution towards insolvency. In fact, the negative feedback loop between liquidity needs and insolvency fears was the dynamic that helped propel the collapse of Bear Stearns and Lehman Brothers. The Board's Proposed Rule may make such a scenario more likely, given that it effectively substitutes the difficult-to-value mortgage-backed securities that brought down the financial system in 2008 with thinly-traded, difficult-to-value municipal securities.

Delegating responsibility to financial institutions for determining creditworthiness effectively nullifies the "investment grade" requirement.

Recognizing that some—if not most—municipal securities may not be liquid in the midst of significant financial stress, the Board has proposed that only those U.S. general obligation municipal securities that are "investment grade" would count as HQLAs under the LCR. Unfortunately, the Proposed Rule does not set forth the criteria that define "investment grade." Instead, the Proposed Rule "relies on an assessment by the bank of the capacity of the issuer to meet its financial commitments." The proposed delegation is reminiscent of the self-regulation and self-policing regulatory approach that failed in the years before the crash and were a contributing cause of the crash.

In other words, the Proposed Rule delegates to financial institutions both the responsibility and the authority to determine whether a municipal security is "investment grade." The Proposed Rule defines "investment grade" as requiring a low risk of default on the municipal security and an expectation of timely repayment and interest. However, the Proposed Rule sets forth no criteria, standards, or methods by which financial institutions are to make those determinations or which the Board will use to assess the adequacy of those determinations.

Rather than relying on the vague and amorphous category of "investment grade," the Proposed Rule should instead set forth a comprehensive and prescriptive list of criteria that financial institutions must consider in determining whether a U.S. general obligation municipal security is in fact "investment grade." Setting forth such a comprehensive and prescriptive list will minimize the likelihood that financial institutions will use standards that will overstate the creditworthiness of the municipal security, thus ensuring that the security will in fact improve the liquidity risk profile of the institution that holds it.

Moreover, setting forth a comprehensive and prescriptive list of criteria that financial institutions must consider will make it easier for the Board and other regulators to independently verify the credit assessments of these municipal securities. In addition, the Proposed Rule should also require institutions to document their credit analyses to facilitate regulatory oversight.

Unless the Board provides such criteria as part of its Proposed Rule, assessments by financial institutions of the creditworthiness of these municipal securities will be unavoidably subjective. Efforts by the Board to ensure that financial institutions are holding only municipal securities that are "investment grade"—and thus a real source of liquidity in a time of stress—will devolve into discussions about creditworthiness that depend on the eye of the beholder.

Financial institutions will feel pressure to adopt the most lenient standards possible, given that, if they do not, their competitors almost surely will. And the Board and regulators will not have an objective and uniform standard to use in assessing the creditworthiness determinations made by financial institutions, or to point to in challenging financial institutions that have included less-than-investment-grade municipal obligations among their HQLAs. Thus, the Proposed Rule makes it likely that the LCR will not work as intended and will make it difficult if not impossible for regulators to supervise and police.

CONCLUSION

The 2008 financial crisis demonstrated the paramount importance of sound and consistent regulations aimed at ensuring that financial institutions maintain sufficient liquidity to withstand periods of great economic stress. As Professor Goodhart points out, if left to their own devices, many—if not most—large, complex financial institutions would outsource responsibility for managing their liquidity needs in times of crisis to central banks.

A properly-designed and implemented LCR would help shift the burden of managing liquidity from central banks—and the governments, societies, and taxpayers those banks are intended to serve—back to the financial institutions that for too long have been complacent about liquidity in times of crisis, which has had the effect of making crises more likely. Given the LCR's importance in helping to prevent financial crises, the Board should be extremely cautious about weakening the LCR by allowing large, complex financial institutions to count municipal securities as HQLAs. The era of weak rules and delegating self-regulation and self-policing to large, complex financial institutions should be long over, especially regarding something as critical as liquidity in times of stress.

We hope these comments are helpful to the Board as it considers the final rule.

Sincerely,

Dennis M. Kelleher
President & CEO

Frank Medina
Senior Counsel and Director of Research

Better Markets, Inc.

Suite 1080
1825 K Street, N.W.
Washington, D.C. 20005
(202) 618-6464

dkelleher@battermarkets.com
fmedina@bettermarkets.com

www.bettermarkets.com